DOW THEORY LETTERS INC.

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THE MARKET: The major advance in the market progressed in faultless fashion from October, 1962, to October, 1964. From that time on the advance became a "solo performance" with Industrials pushing to successive new all-time highs while Rails refused to confirm (study Chart 1).

The action of the carriers since mid-January, 1965, has been most extraordinary. For four months the Rail Average has held within a very tight range bordered by the February low of 207.09 and the March high of 215.98. This represents a range of less than 4%. The question is, are informed investors (rails tend to be traded by the professional element in the market) now accumulating or distributing the rails? The answer to this question might well determine the future course of the whole market.

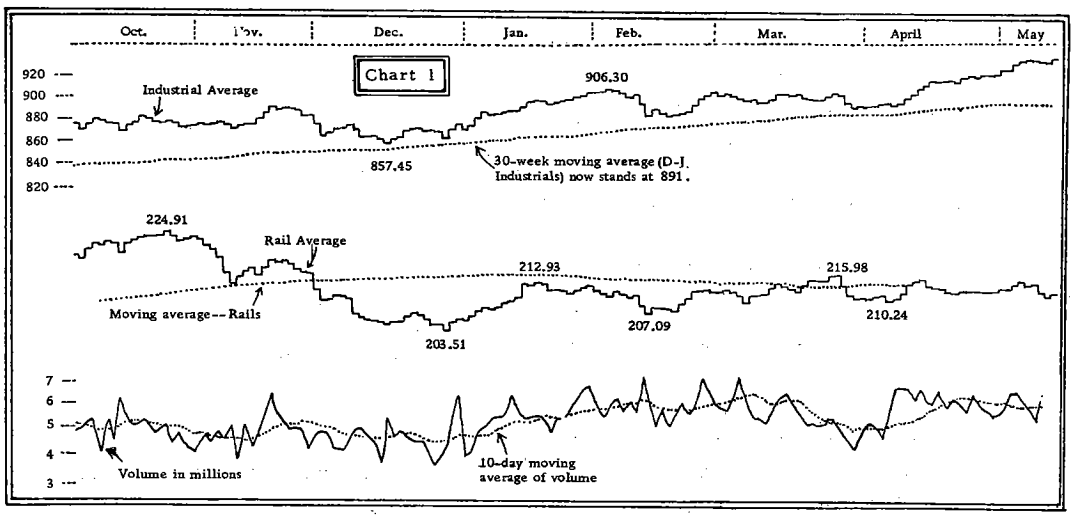
This writer has emphasized that Industrials can continue to advance as long as they have some sort of technical "OK" from the Rail Average. In the last two Letters I noted that since December, 1964, Rails have built a series of ascending bottoms — 203.51 in December, 207.09 in February, 210.24 in April. As long as this series remained intact, I wrote that I felt that Industrials could continue to make progress. However, I also stated that I believed a rupturing of the series of ascending Rail bottoms would mark a very distinct "danger signal" for the market.

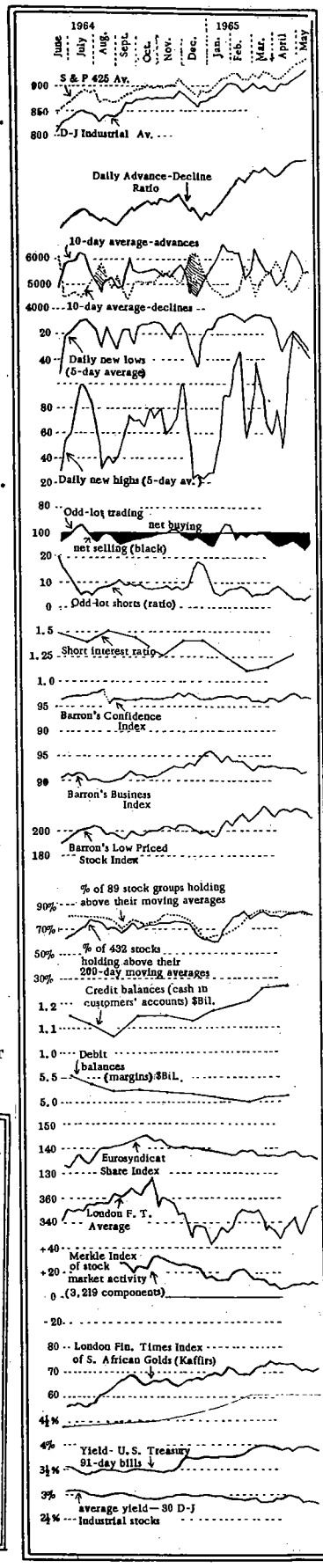
In Letter 287 I dissected the Rail Average (noting each rail stock's position above or below its 200-day or long-term moving average). The "score" in Letter 287 was 12 rails bearish, 1 neutral and 7 bullish. The score has now turned increasingly unfavorable with 13 rail issues bearish and 7 bullish.

With industrial production soaring, with new car sales holding at breath-taking levels, with consumer installment debt surging, we might normally expect that the Rail Average (which to a large extent reflects future trends in carloadings) would be pushing to new highs. This is not occurring, and one is reminded of that old Wall Street rule: "When the market belies the obvious, it is time to be on one's guard."

Conclusion: The primary trend is bullish, the secondary trend is obscure but will be bullish if Rails can better their March high of 215.98. The minor (daily) trend is also obscure. Volume indications continue to favor the bull side with most of the expansion in volume occurring on rallying days and the contraction taking place on declines.

The Composite Chart shows the two leading industrial averages near record highs with the A-D ratio now lagging slightly. Barron's Confidence Index has failed for six months to surpass its November (97.6) peak. Barron's Low-Priced Stock Index has just traced its first downward zig-zag of the year. The percentage of stocks holding above their moving average holds at a very high level of 81%. The Eurosyndicat Index still looks bearish, but London now looks stronger



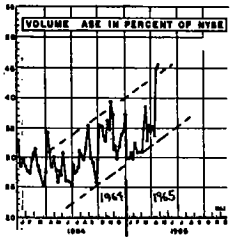

1964
1965
S & P 425 Av.
D-J Industrial Av.
Daily Advance-Decline Ratio
10-day average-advances
10-day average-declines
Daily new lows (5-day average)
Daily new highs (5-day av.)
Odd-lot trading
net buying
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low Priced Stock Index
% of 89 stock groups holding above their moving averages
% of 432 stocks holding above their 200-day moving averages
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London F. T. Average
Merkle Index of stock market activity (3,219 components)
London Fin. Times Index of S. African Golds (Kaffirs)
Yield- U.S. Treasury 91-day bills
average yield— 30 D-J industrial stocks

than any time since the 1964 peak. Despite a continuing stream of news regarding U. S. and British success in their balance-of-payments and despite weakness in Canadian gold shares, the Kaffirs (S. African) gold index is holding within 3½ points of its 1965 high. The abnormal span between the yield on U. S. 91-day Treasury bills and the yield on the Dow continues wide with the Dow yield dropping to a new low of 2.8% this week. Conclusion: no definitive accumulation of danger signals from the composite chart as yet, but faint cracks are beginning to show in the bull market's seams.

RELATIVE STRENGTH: Except for the Dow Theory itself, I believe that the most valuable segment of technical market analysis is the study of relative strength. Relative strength (RS) answers one simple but critical question: "How is a given stock doing compared to the general market (i.e., the market as measured by the Standard & Poor 500 or any other broad gauge).

RS studies were first brought to the attention of the public by Robert Rhea writing in Barron's, May 8, 1933. Rhea's first article was entitled "Stock Habits." In that piece Rhea explained RS in terms of statistics which he called "index numbers." These index numbers were nothing more than the percentages by which a given stock outperformed or lagged behind the D-J Industrial Average. When such percentages are charted on semi-logarithmic graph paper (a process which Rhea advocated) they form a line which is actually a RS measurement indicating (on a continuing basis) whether a stock is acting better or worse than the market. (Rhea also suggested charting a stock's volume as a percentage of total market volume, a potential field of study which has never received real attention — even to this day).

SPRING PSYCHOLOGY: The psychology surrounding the current market is as fascinating as anything this writer has seen in years. Many of the gauges of speculative sentiment are now in conflict. For instance, odd-lotters (see chart on Page 1) have remained consistently on the selling side of the market, and this would seem to suggest public caution. Yet mutual fund sales have been booming while fund redemptions have contracted sharply. Another speculative gauge, Amex volume (the Amex is our more speculative exchange) as a percentage of N.Y.S.E. volume has been climbing over the last few months, and during the past few weeks it has boomed (see chart). In late 1961 Amex volume jumped to from 38% to 51% of N.Y.S.E. volume, and we know that anything above 35% can be considered speculative. Thus there are definite signs that the public has been quite active in this market.



From the standpoint of the professional analysts, the situation is equally fascinating. There is no questioning the fact that the majority of newer market services are bullish. But most of these services have not received their "baptism of fire" (i.e., for instance, going through a collapse while urging readers to "keep buying") so I take them with the proverbial "grain of salt." But the old line services, the ones I really respect, are particularly interesting at this time. Joseph Granville (his service is new but he's been a Wall Street writer for years) is quite bearish. In his latest report he states: "The prudent investor should welcome the opportunity to let the traders take over while he pulls out and generally 'calls it a day'."

E. George Schaefer has been writing about a "950-975 danger zone." Schaefer, after being the most consistent bull in the nation since 1949, is now turning bearish, and he will regard any upside action over the period ahead as a "selling zone." In his latest Letter Schaefer writes: "The very speed of the recent climb for the DJIA promises to 'burn itself out,' probably this summer sometime." Later Schaefer says: "But, I believe that — once the Industrials smash and start rolling down the hill into a primary bear market — the downslide will be so fast and so great that anything you have sold anywhere near the 950-975 danger zone will then begin to look like one of the best things you ever did."

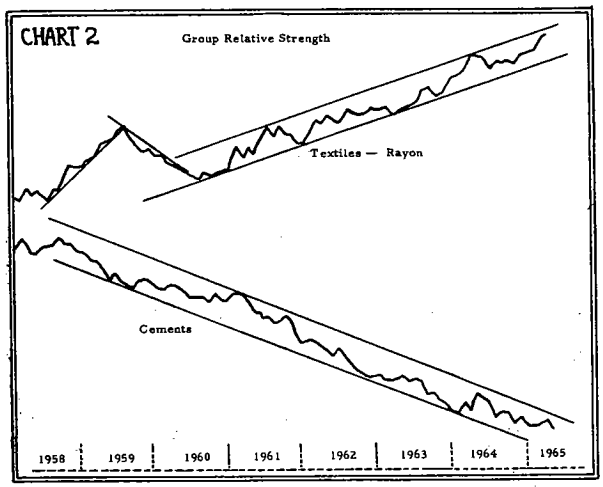
A. Hamilton Bolton, leading bank credit analyst, believes (based on his declining debit-loan ratio) that corporate profits probably "topped out" in the last quarter of 1964 or the first quarter of 1965 and that overall corporate profits in 1965 will not be as favorable as in 1964. In his latest (May) report Bolton writes: "Our view remains that 1965 will probably see the termination of the complete postwar bull market due to the impact of several economic factors arriving at approximately the same time: (1) The end of the normal business cycle which has been prolonged by the relatively too great expansion of credit. (2) The end of overexpansion of credit itself. (3) The coming economic crisis in Europe, as international liquidity shrinks rapidly under the impact of balancing the U. S. payments deficits."

Anthony Gaubis, a veteran, highly-respected Wall Street analyst, suspects that we are at or very near a cyclical top. Gaubis expects a drop during the summer or fall which could in many ways resemble 1946 or 1937. However, Gaubis feels that any decline will be rapid and violent and that the market could be heading up again by fall. Gaubis believes that too many technicians are now looking at the same things, and that if the market starts falling, there could be an avalanche of "sell signals" from all technical quarters at once. This could serve to render any decline quick and violent.

It should be remembered that RS tells the investor what to buy but never when to buy it. In other words, RS is an identification tool — not a timing tool. RS as an investment aid is based on one simple principle: stock groups and individual stocks are subject to important and often long-lasting changes in fortune. When a company's outlook is improving, that company may outperform the general market for many months or even years. The converse is true when a company's outlook deteriorates (it should be remembered that RS trends almost always last longer than price trends). The easiest method of identifying changes in RS entails the simple process of plotting RS lines on graph paper and drawing obvious trendlines.

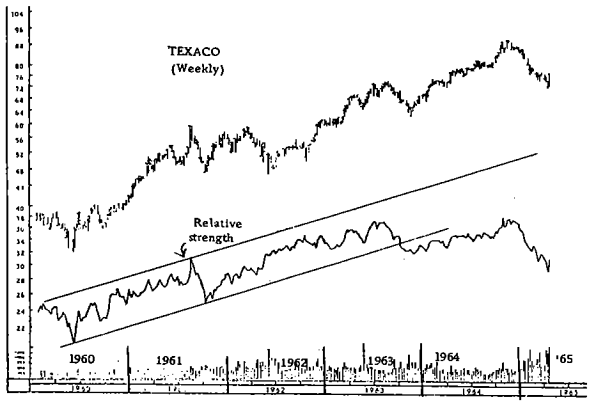
RS can serve to put the investor in the "right" group; it can also serve to keep him out of trouble. I have used two extreme current examples to illustrate this point. Note on Chart 2 that the rayon textile group turned up in RS during late-1960. The continuing rise in group RS was particularly impressive during 1962 when (despite the collapse in the general market) the rayon group never faltered in its "better-than-the-market" performance. This type of action — a continued rise in a stock's or a group's RS in the face of a falling market — is usually the best and safest method of picking the "winners" for the next major market advance. It might be well to add that during 1960 and 1961 (when the spectacular performance in rayons began) this group was subject to the most bitter derision on Wall Street. Such issues as Stevens, American Enka, Burlington, Celanese, etc., we considered "hopeless companies" locked into an industry which would never get better. But group RS was saying that the situation was changing.

CHART 2 Group Relative Strength

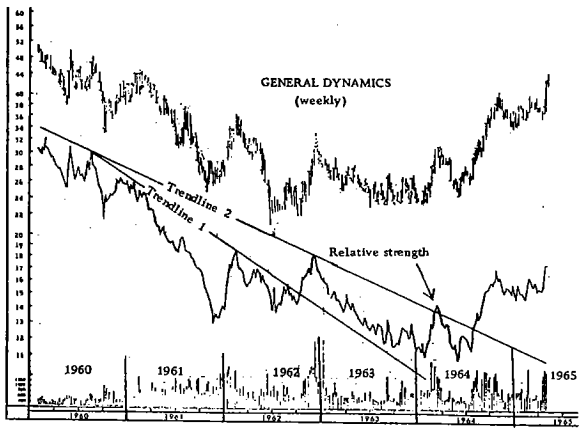


On the other hand, the cement group continues to be gripped by the most persistent RS collapse on the board. Cements have performed worse than the market for seven consecutive years. Sooner or later, however, we know that just as the rayon group will turn down, so the cement group will turn up. Cements have few friends now; no one knows how much longer this great industry is fated to languish. But one thing I have learned (often to my cost

and discomfort); I do not "jump the gun" on RS. If I do any buying in cement issues, it will be after the cement group breaks out of its long RS decline. Such a reversal could come this summer, or it could come in 1970. RS studies will identify the turn, they will not predict. An interesting observation is that the greater and the longer the RS decline, the better the odds for an important and profitable rise when the reversal comes.



It should be remembered that RS is not "the magic key" to stock market millions any more than any other helpful market tool. As a matter of fact, RS charts are often difficult to read or interpret. Take the chart of Texaco. This stock went into a long uptrend in RS starting in 1960. TX's 1962 performance was magnificent, and the rising RS channel continued into mid-1963. From mid-1963 on TX's RS dropped below the previous rising channel, but its RS nevertheless continued to rise. This is not an uncommon phenomenon in RS. In this writer's experience the odds favored the seller of TX in mid-1963. Note, however, that the seller would have been very premature, and when TX rose to new all-time highs during 1964 the seller might have bemoaned the fact that he ever heard of RS. In late 1964, however, the trouble materialized. Between November, 1964, and April, 1965, TX dropped from 92 to 73. Did the early (1963) break in TX below its RS channel mean anything? I believe that it indicated early distribution, distribution the effect of which was not seen until late 1964.



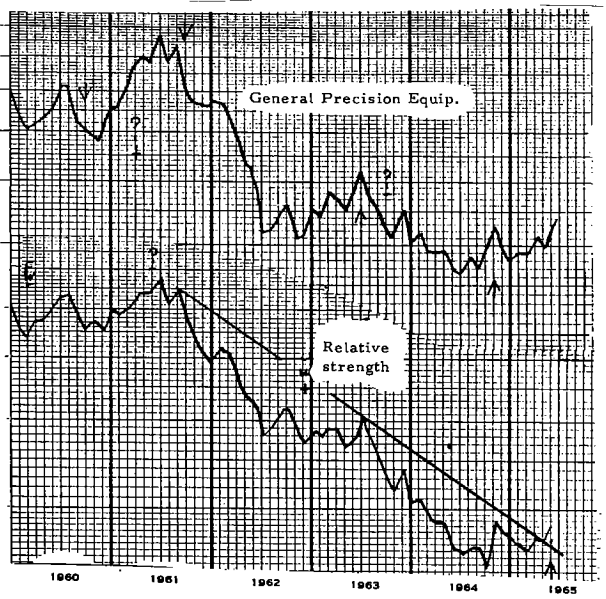
Somewhat the converse of the TX situation can be seen in General Dynamics. GD underwent a shocking collapse during 1960-62. In late-1962 GD reversed its declining RS trendline (trendline marked 1 on chart). After a fourth quarter rally in 1962, GD settled back, and its RS line continued to slide to new lows all during 1963 (but the new lows occurred above trendline 1). A new RS trendline encompassing all the action of 1960-64 (trendline 2) was drawn. In mid-1964 this new trendline was bettered, and this action proved to be the signal for a dynamic advance in GD, an advance which is in effect as of this writing. I might add that (1) GD has now doubled since its 1962 lows, (2) following the bettering of trendline 1 the stock never broke below its 1962 low, (3) while GD was improving on a RS basis, talk here in San Diego (where the giant Convair plants of GD are located) was that GD might even go out of business. The market was saying something quite different, however.

THE MONSTERS: Technical students often wonder what five or six stocks to scrutinize in an effort to obtain possible advance hints as to the future course of the economy or the market. Here they are: according to latest computations the following six issues comprise almost 25% of the value of all the stocks listed on the N.Y.S.E. — G.M., Telephone, DuPont, Texaco, Standard of Jersey, I.B.M.

SUNDRY COMMENTS: My wife, having just returned from three weeks in N.Y.C., tells me that the optimism there has to be seen to be believed (much more optimism than in the West). At parties she reports that she did not even have the nerve to question the bullish chatter ("they would have thought I was a Communist!"). The old rule is that everything travels from East to West in the U. S. This suggests a rising tide of bullishness out here this summer — but it has not hit us yet. A second comment: last night I talked to one of my oldest friends, a big trader who is "in" with the "big numbers boys" on Wall Street. His comment: "We're all so loaded with merchandise that we couldn't buy anything more if they served it to us on a silver platter." In other words, if the big traders do any selling, that selling is slated to appear in the months ahead, it has not occurred yet.

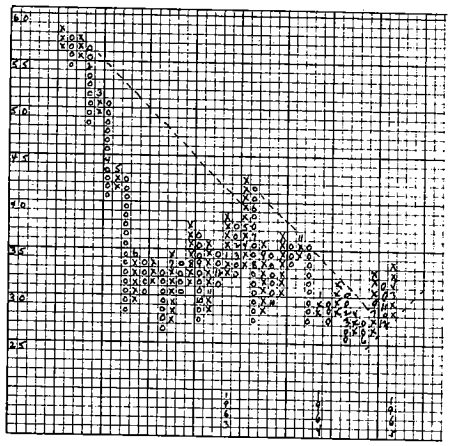
Social Commentaries: Towards the end of every new era the public becomes jaded, and the search for thrills intensifies. In most cases, from the Roman orgies to the "flapper parties" of the 1920's, the search resolves itself in sex. The preoccupation with sex is now reaching remarkable levels. Note the emphasis on sex in advertising: "Be a Mustanger," or this heading from a full page ad in the current issue of Newsweek: "Darling, do you know what 500 women said they like a man to do?". Note the sexualization of social dancing via the frug, watusi, etc. Note the emphasis on sex in womens' clothes, the bikini, short skirts, and from this week's issue of Life, the part-sweater: "More Girl Than Sweater" says the heading. The movies are currently preoccupied with sex. James Bond has captured the 1960's to a much greater extent than Bogart ever captured the 1940's. Bond is all action, sophistication, sadism, technician (in bed or out), but there is no love, no emotion (who needs it in 1965?). Finally, the magazines and books are now so "swinging" that they require little comment here. Selby's "Last Exit From Brooklyn" and Burroughs's "Naked Lunch" (both of these books I thought were excellent) took sex and inversion to its logical conclusion. After these two volumes, there is not much more that you can do with sex in literature. California represents a mixture of the best and worst the nation has to offer, and San Diego is California only more so — but look at these statistics from San Diego County, 1964: 6,000 marriages; 4,000 divorces. The writer is hardly posing as a moralist. I merely offer these comments as an aid to identification of the phase. "If this ain't the third phase," commented one of my hipper subscribers, "then man, we're sure closing in on it — and fast."

STOCKS: Fansteel, recommended in the last Letter, jumped a full 10% (!) on April 11 to a new high. The stock needs a rest, but it acts as if it wants to keep going. The silver group acts badly, and this writer dumped his Day Mines at 9½. I wonder if the Administration could be planning a ban on the holding or melting down of silver coinage. They did it to gold — could silver be next? Something appears to be wrong, but it is anybody's guess as to what it is.

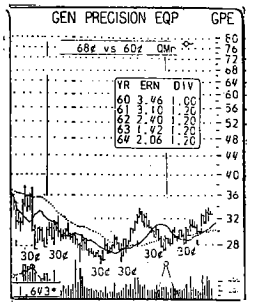


A number of subscribers have been asking me about short sales. The most critical part of shorting is timing — and the time is not here yet. There is no current market evidence to suggest that this is the time for shorting. Such a time could come in a few months, but you can lose a year's sleep in a month with shorts that are going up. If you must be early on the bear side, my suggestion is to buy 1 year "put" options on the big popular stocks such as GM, IBM, Sears, Gen. Foods. The airlines also make good puts at their cyclical peaks (which could well be around here). I might add that puts are always cheapest when the market is in a strong uptrend (few option buyers want to "play" the downside during a bull move). A good check on options is to run through the offerings in the Wall Street Journal. Note now that almost all the options are for calls, so that this is obviously an expensive time to buy calls (a call is a hedge on the upside; a put is a hedge on the downside). A put has one great advantage over a short. When one buys a put, the money is spent, the potential loss is limited (to the extent of the price of the put), and the buyer of the put option (unlike the short seller) cannot get "whipsawed" by his own emotions. As a hypothetical example, a man sells GM short now at 107. GM runs up to 111 and the short seller covers to protect himself. GM then runs up to say 120, tops, then drops to 70 by the end of 1965. The short seller has covered at a loss but the put buyer has probably doubled his money.

GENERAL PRECISION EQUIPT. (GPE)



Right now my opinion is that only out-and-out speculators should be trying for upside profits here. And even on the bull side, you will need all the odds with you. But we will try for the odds. General Precision Equipment is a stock that looks interesting. GPE broke from a high of 77 in 1961 to a low of 26 in 1964. In the process, its RS line sank to its lowest point in history (see monthly chart). In the last month the RS line on GPE has reversed to the upside. This coupled with a rising earnings trend and a "bottomy" looking formation in GPE constitutes reason enough to focus attention on this issue. The small weekly chart shows the recent climb by the 10-week moving average (solid line) above the longer-term 200-day moving average. The price of GPE holds above the 10-week moving average so that all indicators here are in the bullish position. Finally, the point & figure chart of GPE shows a reversal of the second of two inhibiting or bearish trendlines. The first "objective" for GPE should be around 40, and although this would not constitute a very exciting move from here (34), I believe that GPE could get quite speculative if the market decides to "boil" between now and summer.



There is no question but the Canadian gold shares are entering major corrections. This possibility was discussed in Letter 280 under the heading: "Take Profits in Canadian Golds?" Letter 280 stated that "my advice is to take partial profits in Canadian golds at these advanced prices. If the Canadian golds go to new highs, subscribers will have taken good profits and still own some golds. On the other hand, if the Canadian golds react below the last lows, subscribers will have hedged by accepting some profits near the highs." That advice proved sound — however, I personally am holding my Kaffirs, and I will continue to hold my 10% hedge position in these.

THE SCARE FOR TODAY" DEPARTMENT: State and local governments outspent the Federal Government for the first time in the history of our nation during the first quarter of 1965. State and local spending for the quarter $65.5 million, Government spending $64.5!

WATER: My friend Eliot Janeway (economist, publisher of the Janeway Letter — and now syndicated newspaper columnist and radio commentator!) writes that water desalinization is going to be the next major growth industry. I thoroughly agree with Janeway on this, and anyone who lives in the U. S. Southwest is well aware of the water shortage problem. San Diego's big water desalinization unit was recently shipped to the Marine Base in Cuba, but rumor is that we are getting a new unit here. Water desalinization is going to be the answer to a growing problem throughout the world. It's one industry that is bound to grow. The problem is getting information regarding leading companies in this field (Westinghouse is certainly one). I would appreciate hearing from knowledgeable subscribers on this subject.

Charts on Page 3 courtesy of Traders Research, P. O. Box 2644, St. Louis, 16, Mo. Large monthly chart of GPE courtesy of Ray * Signals, 141 Broadway, N. Y. C. 6. Point & Figure chart of GPE courtesy of Chartcraft, Larchmont, New York. Small weekly chart of GPE courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. Chart of AMEX percentage volume courtesy of Merrill Analysis, Box 228, Chappaqua, New York. 10514.